

Chapter 3 - Audit Risk and Risk Assessment

Audit Risk

Meaning

Auditor might express an inappropriate opinion when FS are materially misstated

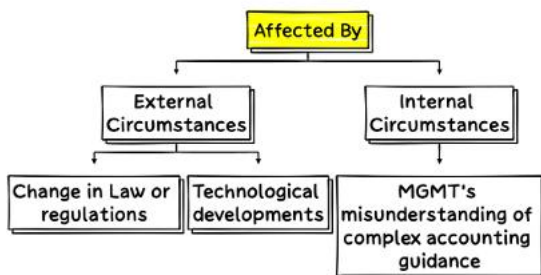
What is not included in Audit Risk	
Risk that auditor might express an Opinion that FS are materially misstated when they are not.	
Does not refer to auditor's business risks such as	loss from litigation
	adverse publicity
	or other events arising in connection with audit of FS

Components of Risk of Material misstatement

Inherent risk

Susceptibility of a/c balance or transaction to a material misstatements because of its nature, assuming there were no IC (a/c balance, transaction mei MMS ke chances because of their nature)

- Higher for some assertions and classes of transactions, account balances, and disclosures
- For example - Complex calculations.
- Considered while designing TOC and SP



EXAMPLE

- Complex accounting standards may not be understood by management, leading to a risk of misstatement in financial statements.
- High business failures in an industry increase the risk of misstatements in financial statements of entities in that industry.

Control risk

Risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

- Reasons for Ineffective Internal Controls -
 - IC is missing
 - IC is not operating effectively

- Flow in design of IC

There exists an **inverse relation** between control risk and efficiency of IC of an entity

Examples
Risk that cash and cheque book control (kept in a locked safe, access to authorized personnel) is not followed.
Risk that fire extinguishers are expired and not refilled, and smoke detectors are non-functional, despite control measures.
Risk that petty cash control (expenses under ₹10,000 routed through imprest system) is not followed.

Both inherent risk and control risk are the **entity's risks** and they exist independently of audit. These risks are not influenced by the auditor.

Risks of material misstatement exist at two level		
Financial statement level	Affecting entire FS	Pervasive - impact all FS items
	Example Ex - risk that Going concern is inappropriate	
	Response - Audit Strategy	
Assertion level for classes of transactions, account balances, and disclosures.	Affecting assertions of line items of FS	
	Example some revenue transactions might be recorded before they are actually earned, leading to overstatement of revenue.	
	Responses - Nature, extent and timing of audit procedures	

Detection Risk

Meaning

Risk that **auditor's procedures** will **not** be able to **detect material misstatements**

Elements of Detection Risk

Sampling risk

Conclusion reached based on sample MAY BE different from conclusion if the population was tested.

Non- Sampling risk

- Factors **not** related to **sampling**
- Examples -
 - Not adequate understanding of the entity.
 - Not able to carry out risk assessment properly.
 - Inadequate audit strategy.
 - Inadequate plan.
 - Incompetent audit program.
 - Misapplication of audit procedures by the team.

- Misinterpretation of test result.
- Poor quality audit management.
- Can be minimised through proper planning(SA 300), assigning appropriate staff, application of professional judgement, proper direction, supervision, and review (SA 220)

Examples of detection risk could include
Auditor skips inventory count for large work-in-progress inventories, relying on alternative procedures.
Auditor samples revenue, but risk exists that the sample is not representative of total revenue.

Other points related to audit Risk

Assessment of risks- A matter of professional Judgment

- The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit.
- The assessment of risks is a matter of **professional judgment, rather** than a matter capable of **precise measurement**.

The assessment of risks in an audit cannot be measured with exact numbers or formulas. Instead, it depends on the auditor's experience, knowledge, and understanding of the client's business, industry, and internal controls. Two auditors might assess the same situation differently based on their individual judgment.

Combined Assessment of the Risk of Material Misstatement

- Auditing standards refer to the "ROMM" rather than inherent and control risk separately.
- Auditors may assess inherent and control risk separately or together.
- Risk assessment can be quantitative (e.g., percentages) or non-quantitative (High, Medium Low).
- Appropriate risk assessment is crucial, regardless of the approach used.

Relationship between risk of material misstatement and detection risk

- Audit risk = Risks of material misstatement x Detection risk or
- Audit risk = Inherent risk x Control risk x Detection risk

Significant risk

- Risk that require special audit consideration is known as significant risk
- Auditor shall determine whether any of the risks identified are significant risk
- He will use his professional judgement for such determination

Factors to be considered while exercising judgement to decide which risk are significant risks

- Whether the risk is a risk of **fraud**
 - Whether the risk is related to recent significant economic, accounting, or other **developments** like changes in regulatory environment etc
 - **Complexity** of transactions
 - Whether the risk involves significant transactions with **related parties**
 - Degree of **subjectivity** in measuring financial information, especially with high measurement uncertainty.
 - Whether risk involves significant transactions that are outside the normal course of business or **unusual** transactions.
- Risk of Fraud - Example: Overstating revenue by recognizing sales before delivery.
 - Recent Economic, Accounting, or Regulatory Changes - Example: New tax laws affecting depreciation or changes in revenue recognition standards.
 - Complexity of Transactions - Example: Derivative contracts for hedging foreign exchange risk requiring complex valuation.
 - Related Party Transactions - Example: Selling raw materials to a subsidiary at preferential prices.
 - Subjectivity in Financial Measurement - Example: Estimating useful life of assets for depreciation or provisions for warranties.
 - Unusual or Non-Routine Transactions - Example: Sale of a major plant or receiving a one-time government subsidy.